DEPARTMENT OF STATE REVENUE

01-20110403.LOF

Letter of Findings: 01-20110403
Individual Adjusted Gross Income Tax
For the Year 2008 and 2009

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ISSUE

I. Adjusted Gross Income Tax – Research Expense Credit.

Authority: IC § 6-3-1-3.5; IC § 6-3-1-11; IC § 6-3-2-1; IC § 6-3.1-4-1; IC § 6-3.1-4-2; IC § 6-3.1-4-4; IC § 6-8.1-5-1; IC § 6-8.1-5-4; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); I.R.C. § 41; I.R.C. § 1012; I.R.C. § 1016; I.R.C. § 1366; I.R.C. § 1367; Treas. Reg. § 1.41-2; Stinson Estate v. United States, 214 F.3d 846 (7th Cir. 2000); United States v. McFerrin, 570 F.3d 672 (5th Cir. 2009); Fudim v. Comm'r, TC Memo 1994-235 (May 26, 1994); Nico v. Commissioner, 67 T.C. 654 (1977); Newman v. Commissioner, 68 T.C. 494 (1977).

Taxpayer protests the disallowance of claimed research and development expense credits.

STATEMENT OF FACTS

Taxpayer files a joint income tax return with his spouse. Taxpayer is a one-hundred percent shareholder of an S corporation ("S Corp") which is a provider of sheet metal components and assemblies to a wide variety of industries, including medical, electronics, communications, appliances, transportation, government, computer, and lawn and garden. Services provided by S Corp consist of laser cutting, sheet metal fabrication, precision machining, welding and assembly.

The Indiana Department of Revenue ("Department") conducted an audit of S Corp for the years 2008 and 2009. S Corp claimed an increase in research activities for 2006 through 2008, which resulted in a "research expense credit" ("REC"). As the sole S Corp shareholder, Taxpayer claimed the REC on his joint individual income tax return. However, during the audit the Department determined that S Corp was unable to substantiate the claimed qualifying research activities and the related expenses and therefore disallowed the credit. The disallowance of the REC resulted in proposed tax assessments. Taxpayer protested the assessments, the Department conducted an administrative hearing, and this Letter of Findings ensues. Further information will be provided as necessary.

I. Adjusted Gross Income Tax – Research Expense Credit.

DISCUSSION

Taxpayer protests the elimination of RECs which it claimed on its 2008 and 2009 joint individual income tax returns, along with the resulting proposed assessments for additional adjusted gross income tax for those periods. Taxpayer argues that the RECs were properly claimed for both years.

Tax assessments are prima facie evidence that the Department's assessment of tax is presumed correct; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Indiana mandates that every person subject to a listed Indiana tax keep books and records, including all source documents "so that the [D]epartment can determine the amount, if any, of the person's liability for that tax by reviewing those books and records." IC § 6-8.1-5-4(a). "If the [D]epartment reasonably believes that a person has not reported the proper amount of tax due, the [D]epartment shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the [D]epartment." IC § 6-8.1-5-1(a).

Similar to deductions, exemptions, and exclusions, tax credits "are matters of legislative grace." Stinson Estate v. United States, 214 F.3d 846, 848 (7th Cir. 2000). The taxpayer who claims a tax credit is required to retain records necessary to substantiate a claimed credit. Where such a credit is claimed "the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96, 100-01 (Ind. Ct. App. 1974). Citing Stinson Estate, the court in United States v. McFerrin summarized that "[t]ax credits are a matter of legislative grace, are only allowed as clearly provided for by statute, and are narrowly construed." United States v. McFerrin, 570 F.3d 672, 675 (5th Cir. 2009).

For income tax purposes, Indiana follows the federal tax scheme with certain modifications. IC § 6-3-2-1(b); IC § 6-3-1-3.5(b). Indiana also provides tax credits which a taxpayer may claim to reduce its taxable income. One of the tax credits is the "Indiana qualified research expense tax credit" under IC § 6-3.1-4-2, which states:

(a) A taxpayer who incurs Indiana qualified research expense in a particular taxable year is entitled to a research expense tax credit for the taxable year.

(b) For Indiana qualified research expense incurred before January 1, 2008, the amount of the research

expense tax credit is equal to the product of ten percent (10[percent]) multiplied by the remainder of:
(1) the taxpayer's Indiana qualified research expenses for the taxable year; minus
(2) the taxpayer's base amount.

(c) Except as provided in subsection (d), for Indiana qualified research expense incurred after December 31, 2007, the amount of the research expense tax credit is determined under STEP FOUR of the following formula:

STEP ONE: Subtract the taxpayer's base amount from the taxpayer's Indiana qualified research expense for the taxable year.

STEP TWO: Multiply the lesser of:
(A) one million dollars ($1,000,000); or
(B) the STEP ONE remainder;
by fifteen percent (15[percent]).

STEP THREE: If the STEP ONE remainder exceeds one million dollars ($1,000,000), multiply the amount of that excess by ten percent (10[percent]).

STEP FOUR: Add the STEP TWO and STEP THREE products.

(d) For Indiana qualified research expense incurred after December 31, 2009, a taxpayer may choose to have the amount of the research expense tax credit determined under this subsection rather than under subsection (c). At the election of the taxpayer, the amount of the taxpayer's research expense tax credit is equal to ten percent (10[percent]) of the part of the taxpayer's Indiana qualified research expense for the taxable year that exceeds fifty percent (50[percent]) of the taxpayer's average Indiana qualified research expense for the three (3) taxable years preceding the taxable year for which the credit is being determined. However, if the taxpayer did not have Indiana qualified research expense in any one (1) of the three (3) taxable years preceding the taxable year for which the credit is being determined, the amount of the research expense tax credit is equal to five percent (5[percent]) of the taxpayer's Indiana qualified research expense for the taxable year.

IC § 6-3.1-4-1 defines terms relevant to the Indiana research expense credit:

As used in this chapter:

"Base amount" means base amount (as defined in Section 41(c) of the Internal Revenue Code as in effect on January 1, 2001), modified by considering only Indiana qualified research expenses and gross receipts attributable to Indiana in the calculation of the taxpayer's:
(1) fixed base percentage; and
(2) average annual gross receipts.

"Indiana qualified research expense" means qualified research expense that is incurred for research conducted in Indiana.

"Qualified research expense" means qualified research expense (as defined in Section 41(b) of the Internal Revenue Code as in effect on January 1, 2001).

"Pass through entity" means:
(1) a corporation that is exempt from the adjusted gross income tax under IC 6-3-2-2.8(2);
(2) a partnership;
(3) a limited liability company; or
(4) a limited liability partnership.

"Research expense tax credit" means a credit provided under this chapter against any tax otherwise due and payable under IC 6-3.

"Taxpayer" means an individual, a corporation, a limited liability company, a limited liability partnership, a trust, or a partnership that has any tax liability under IC 6-3 (adjusted gross income tax).

IC § 6-3.1-4-4 provides:

The provisions of Section 41 of the Internal Revenue Code as in effect on January 1, 2001, and the regulations promulgated in respect to those provisions and in effect on January 1, 2001, are applicable to the interpretation and administration by the department of the credit provided by this chapter, including the allocation and pass through of the credit to various taxpayers and the transitional rules for determination of the base period.

"Qualified research" is defined in I.R.C. § 41(d), as follows:

(1) In general.--The term "qualified research" means research--
(A) with respect to which expenditures may be treated as expenses under section 174,
(B) which is undertaken for the purpose of discovering information--
(i) which is technological in nature, and
(ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
(C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3). Such term does not include any activity described in paragraph (4).

(2) Tests to be applied separately to each business component.--For purposes of this subsection--

(A) In general.--Paragraph (1) shall be applied separately with respect to each business component of the taxpayer.

(B) Business component defined.--The term "business component" means any product, process, computer software, technique, formula, or invention which is to be--

(i) held for sale, lease, or license, or

(ii) used by the taxpayer in a trade or business of the taxpayer.

(C) Special rule for production processes.--Any plant process, machinery, or technique for commercial production of a business component shall be treated as a separate business component (and not as part of the business component being produced).

(3) Purposes for which research may qualify for credit.--For purposes of paragraph (1)(C)--

(A) In general.--Research shall be treated as conducted for a purpose described in this paragraph if it relates to--

(i) a new or improved function,

(ii) performance, or

(iii) reliability or quality.

(B) Certain purposes not qualified.--Research shall in no event be treated as conducted for a purpose described in this paragraph if it relates to style, taste, cosmetic, or seasonal design factors.

(4) Activities for which credit not allowed.--The term "qualified research" shall not include any of the following:

(A) Research after commercial production.--Any research conducted after the beginning of commercial production of the business component.

(B) Adaptation of existing business components.--Any research related to the adaptation of an existing business component to a particular customer's requirement or need.

(C) Duplication of existing business component.--Any research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component.

(D) Surveys, studies, etc.--Any--

(i) efficiency survey,

(ii) activity relating to management function or technique,

(iii) market research, testing, or development (including advertising or promotions),

(iv) routine data collection, or

(v) routine or ordinary testing or inspection for quality control.

(E) Computer software.--Except to the extent provided in regulations, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer, other than for use in--

(i) an activity which constitutes qualified research (determined with regard to this subparagraph), or

(ii) a production process with respect to which the requirements of paragraph (1) are met.

(F) Foreign research.--Any research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States.

(G) Social sciences, etc.--Any research in the social sciences, arts, or humanities.

(H) Funded research.--Any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

"Qualified research expenses" are described at I.R.C. § 41(b) and provide:

Qualified research expenses.--For purposes of this section--

(1) Qualified research expenses.--The term "qualified research expenses" **means the sum of the following amounts which are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer**--

(A) **in-house research expenses**, and

(B) contract research expenses.

(2) **In-house research expenses**.--

(A) In general.--The term "in-house research expenses" means--

(i) **any wages paid or incurred to an employee for qualified services performed by such employee,**

(ii) any amount paid or incurred for supplies used in the conduct of qualified research, and

(iii) under regulations prescribed by the Secretary, any amount paid or incurred to another person for the right to use computers in the conduct of qualified research.

Clause (iii) shall not apply to any amount to the extent that the taxpayer (or any person with whom the taxpayer must aggregate expenditures under subsection (f)(1)) receives or accrues any amount from any other person for the right to use substantially identical personal property.

(B) **Qualified services**.--The term "**qualified services" means services consisting of**--

(i) **engaging in qualified research, or**

(ii) engaging in the direct supervision or direct support of research activities which constitute qualified research.

If substantially all of the services performed by an individual for the taxpayer during the taxable year consists of services meeting the requirements of clause (i) or (ii), the term "qualified services" means all of the services performed by such individual for the taxpayer during the taxable year.

(C) Supplies.--The term "supplies" means any tangible property other than-

(i) land or improvements to land, and

(ii) property of a character subject to the allowance for depreciation.

(D) Wages.--

(i) In general.--The term "wages" has the meaning given such term by section 3401(a).

(ii) Self-employed individuals and owner-employees.--In the case of an employee (within the meaning of section 401(c)(1)), the term "wages" includes the earned income (as defined in section 401(c)(2)) of such employee.

(iii) Exclusion for wages to which work opportunity credit applies.-The term "wages" shall not include any amount taken into account in determining the work opportunity credit under section 51(a).

(**Emphasis added**).

Treas. Reg. § 1.41-2 further illustrates "qualified research expenses," in relevant part:

(a) Trade or business requirement--(1) In general. An in-house research expense of the taxpayer or a contract research expense of the taxpayer is a qualified research expense **only if the expense is paid or incurred by the taxpayer in carrying on a trade or business of the taxpayer**. The phrase "**in carrying on a trade or business" has the same meaning for purposes of section 41(b)(1) as it has for purposes of section 162**; thus, expenses paid or incurred in connection with a trade or business within the meaning of section 174(a) (relating to the deduction for research and experimental expenses) are not necessarily paid or incurred in carrying on a trade or business for purposes of section 41. **A research expense must relate to a particular trade or business being carried on by the taxpayer at the time the expense is paid or incurred in order to be a qualified research expense**. For purposes of section 41, a contract research expense of the taxpayer is not a qualified research expense if the product or result of the research is intended to be transferred to another in return for license or royalty payments and the taxpayer does not use the product of the research in the taxpayer's trade or business.

...

(c) **Qualified services**–

(1) Engaging in qualified research. The term "engaging in qualified research" as used in section 41(b)(2)(B) means the actual conduct of qualified research (as in the case of a scientist conducting laboratory experiments).

(2) **Direct supervision. The term "direct supervision" as used in section 41(b)(2)(B) means the immediate supervision (first-line management) of qualified research (as in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments). "Direct supervision" does not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist**.

(3) **Direct support. The term "direct support" as used in section 41(b)(2)(B) means services in the direct support of either**--

(i) **Persons engaging in actual conduct of qualified research, or**

(ii) **Persons who are directly supervising persons engaging in the actual conduct of qualified research.** For example, direct support of research includes the services of a secretary for typing reports describing laboratory results derived from qualified research, of a laboratory worker for cleaning equipment used in qualified research, of a clerk for compiling research data, and of a machinist for machining a part of an experimental model used in qualified research. Direct support of research activities does not include general administrative services, or other services only indirectly of benefit to research activities. For example, services of payroll personnel in preparing salary checks of laboratory scientists, of an accountant for accounting for research expenses, of a janitor for general cleaning of a research laboratory, or of officers engaged in supervising financial or personnel matters do not qualify as direct support of research. This is true whether general administrative personnel are part of the research department or in a separate department. Direct support does not include supervision. Supervisory services constitute "qualified services" only to the extent provided in paragraph (c)(2) of this section.

...

(d) **Wages paid for qualified services**--(1) In general. **Wages paid to or incurred for an employee constitute in-house research expenses only to the extent the wages were paid or incurred for qualified services performed by the employee**. **If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense**. **In the absence of another method of allocation that the taxpayer can demonstrate to be more appropriate, the amount of in-house research expense**

shall be determined by multiplying the total amount of wages paid to or incurred for the employee during the taxable year by the ratio of the total time actually spent by the employee in the performance of qualified services for the taxpayer to the total time spent by the employee in the performance of all services for the taxpayer during the taxable year.

(2) "Substantially all." Notwithstanding paragraph (d)(1) of this section, if substantially all of the services performed by an employee for the taxpayer during the taxable year consist of services meeting the requirements of section 41(b)(2)(B) (i) or (ii), then the term "qualified services" means all of the services performed by the employee for the taxpayer during the taxable year. Services meeting the requirements of section 41(b)(2)(B) (i) or (ii) constitute substantially all of the services performed by the employee during a taxable year only if the wages allocated (on the basis used for purposes of paragraph (d)(1) of this section) to services meeting the requirements of section 41(b)(2)(B) (i) or (ii) constitute at least 80 percent of the wages paid to or incurred by the taxpayer for the employee during the taxable year. (**Emphasis added**).

Thus, if a taxpayer wishes to exempt "wages paid to or incurred for an employee" under the "qualified research expense tax credit," the taxpayer must show that these wages constitute in-house research expenses. In-house research expenses are earned when the employee was performing qualified activities within a qualified research project. However, to claim the Indiana qualified research expense tax credit on wages incurred, the taxpayer must first demonstrate that its activities meet the statutory/regulatory requirements of "qualified research," as defined in I.R.C. 41(d), and that the "qualified research" activities were conducted in Indiana in carrying on a trade or business of the taxpayer. Second, after meeting the statutory/regulatory requirements, the taxpayer may only include in-house research expenses and contract research expenses paid or incurred by the taxpayer when the taxpayer demonstrates that the research expenses were incurred in carrying on any qualified research activities in Indiana.

"In-house research expenses" include "wages paid or incurred to an employee for qualified services" performed in Indiana and amounts paid or incurred for "supplies used in the conduct of qualified research" in Indiana. Indiana adopts federal interpretations of "qualified services," which include (1) services rendered in performing qualified research; (2) direct supervision of qualified research activities; and/or (3) direct support of qualified research activities. IC § 6-3.1-4-4; Treas. Reg. § 1.41-2(c)(1), (2), (3).

"'Direct supervision' means the immediate supervision (first-line management) of qualified research (as in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments)." Treas. Reg. § 1.41-2(c)(2). "'Direct supervision' does not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist." Id. "'Direct support' of qualified research activities includes services in the direct support of '(i) [p]ersons engaging in actual conduct of qualified research,' or '(ii) [p]ersons who are directly supervising persons engaging in the actual conduct of qualified research.'" Treas. Reg. § 1.41-2(c)(3). Additionally, "direct support of research includes the services of a secretary for typing reports describing laboratory results derived from qualified research, of a laboratory worker for cleaning equipment used in qualified research, and of a clerk for compiling research data, and of a machinist for machining a part of experimental model used in qualified research." Id. However, "[d]irect support of research activities does not include general administrative services, or other services, or other services only indirectly of benefit to research activities." Id. Furthermore, "[w]ages paid to or incurred for an employee constitute in-house research expenses only to the extent the wages were paid or incurred for qualified services performed by the employee." Treas. Reg. § 1.41-2(d)(1). "If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense." Id.

Thus, only when a taxpayer demonstrates that wages paid or incurred to employees for qualified services performed by its employees for Indiana qualified research, is the taxpayer entitled to the Indiana qualified research expense tax credit.

When the taxpayer demonstrates that it conducts Indiana qualified research and its employees perform "qualified services" relating to that research, Indiana permits the taxpayer to calculate the REC using appropriate income ratios. The taxpayer may "[i]n the absence of another method of allocation that the taxpayer can demonstrate to be more appropriate," determine the claimed tax credit on wages "by multiplying the total amount of wages paid to or incurred for the employee during the taxable year by the ratio of the total time actually spent by the employee in the performance of qualified services for the taxpayer to the total time spent by the employee in the performance of all services for the taxpayer during the taxable year." Id.

The Department's audit of S Corp states that S Corp did not sufficiently document its claimed qualifying research activities necessary to meet its burden to show that those activities were exempt. Even presuming that the research activities Taxpayer/S Corp claimed actually did qualify for the REC, the Department's audit found that Taxpayer/S Corp did not sufficiently document the claimed qualifying research expense credits (primarily related to wages) related to the research activities.

The Department's audit, as discussed above, determined that S Corp was unable to properly substantiate the claimed research expenses and therefore disallowed the credit.

This Letter of Findings addresses whether S Corp's level of documentation is sufficient to show that the wage

expenses for which Taxpayer is claiming Indiana REC is sufficient to support the estimate of time spent by S Corp's employees on qualifying research and development projects.

S Corp, in the person of Taxpayer, based its calculation of the REC on a combination of factors. First, S Corp tracked some information for each of the research and development projects it undertook for the years at issue. Second, Taxpayer used a baseline percentage that had been developed several years prior by a third-party consulting firm ("CF") to make an "educated" estimate of current year percentages. According to Taxpayer, the baseline developed by CF determined which employees were working on qualified research activities and then determined what percentage of each employee's wages related to those activities. These percentages became each employee's baseline for determining the exempt percentages of wages each subsequent year. At the end of each year, Taxpayer himself estimated the percentage of time his employees allocated to research and development projects that particular year.

The Department's audit report explains the process as follows:

> As part of the process in determining whether the activities claimed by the taxpayer are qualified research, this auditor met with the president of the company, [] and [], engineer manager. [Taxpayer] explained that he was contacted by an outside consulting company sometime between 2003 and 2005. This consulting company interviewed employees and determined the percentage of wages each employment position would qualify for REC, based upon the consulting company's definition of qualified activities. For 2008 and 2009, [Taxpayer] used a percentage which was slightly less for each of the positions. For example, if the consulting company determined that the eighty percent (80[percent]) of the wages of a particular position would qualify for research expense, then [Taxpayer] would claim 70[percent] or 75[percent] for that particular position as qualified research in 2008 and 2009.
>
> This auditor requested documentation to support the above percentages. [Taxpayer] stated that he had no documentation; he relied upon his knowledge of the business activity. [Taxpayer] has estimated the percentage of wages for each employee that would qualify for REC, as defined by [Taxpayer].
>
> This auditor requested documentation to identify the particular projects or research activities that were conducted in 2008 (and the employees associated with those projects). [Taxpayer] said that this documentation is not available. This auditor also spoke with [the engineer] who stated that he has never maintained any records or logs indentifying *[sic]* the types of activities that he or his staff worked on for any project.
>
> A taxpayer that claims the research expense credit not only must be engaged in qualified research activities, that taxpayer must also maintain sufficient records detailing and substantiating the expenditures claimed as eligible for the credit. Records of a taxpayer claiming a research credit must be maintained in sufficient detail so that it would allow the federal or state (Indiana) to verify the total amount of the expenditure reported on the return.

In investigating the research expense credit taken by Taxpayer, the Department's auditor requested the documentation upon which S Corp had relied in claiming the credit. Taxpayer stated that the consulting firm conducted a "research expense credit" study at S Corp in the early 2000s. According to Taxpayer, the consulting firm it hired ("CF") interviewed S Corp's employees and determined the baseline of research expense credit that S Corp was entitled to. The majority of the credit represented wages.

Taxpayer provided the following documentation to the Department's auditor: (1) a 4-page analysis by CF that found S Corp qualified for the research expense credit a few years prior to the audit (note that neither S Corp nor Taxpayer had retained the underlying documentation); (2) the job titles and job descriptions for all individuals listed on the wage workpaper; and (3) the workpaper showing the percentage of wages which were allocated to research. When queried by the Department's auditor as to the source of S Corp's wage percentages, Taxpayer stated that CF told him S Corp qualified for an 80 percent allocation. Taxpayer believed then that if S Corp used a percentage less than 80 percent, that would be acceptable.

The Department's auditor asked for S Corp's documentation and support justifying the percentage allocation. Taxpayer stated that he had none. Taxpayer stated that he knew what projects the engineers work on during the year, and he then estimated the percentages based on the baseline developed by CF. In response to questions the Department's auditor asked, Taxpayer stated that he would not be able to document what a particular employee did on a particular day, nor which projects a particular employee had worked on. None of CF's work papers were retained by S Corp.

After the hearing, Taxpayer provided additional documentation, along with a cover letter dated January 17, 2012. First, Taxpayer presented 2007 through 2010 R & D employee listings as well as project lists for each of those years. Second, Taxpayer provided a description of seven 2008 sample product development projects. The descriptions listed the product and industry that the research was intended to benefit, the scope of the research and development work performed by the engineers and skilled tradesmen generally assigned to the project (it should be noted, though, that there was no allocation or estimates of the time these employees spent on each project). Also included with each project was a Job Cost Detail sheet that showed costs related to direct labor (not the engineers), and material and outside services associated with the project. The direct labor information was identified by work center, but not individuals' names. Third, Taxpayer presented a 2008 Research and

Development Employee List which included job titles. Attached to this list was a job description of each job title. Lastly, Taxpayer pointed out the list he provided of S Corp's research projects only reflect the product development projects. Taxpayer stated that S Corp's employees were also involved in testing processes the time allocations of which CF had included in its estimated wage allocation for the REC.

Taxpayer notes that "due to the decrease in time spent by the employees on product development and process improvement projects, [S Corp] did not qualify for the federal or state research and development credits in 2010." Taxpayer presents this information as evidence of its good faith and credibility relating to its REC claims for 2008 and 2009.

The use of its consultant's baseline percentages is inappropriate for two reasons: (1) the baseline percentages were developed with a particular set of data, which, according to Taxpayer's own evidence has significantly changed year to year; and (2) the underlying data for the baseline calculations is not available which means the Department has no way of verifying Taxpayer's variation from the baseline year to year.

Again, Indiana adopts the federal interpretation of "qualified services," which includes (1) services rendered in performing qualified research; (2) direct supervision of qualified research activities; and/or (3) direct support of qualified research activities. IC § 6-3.1-4-4; Treas. Reg. § 1.41-2(c)(1), (2), (3). "'Direct supervision' means the immediate supervision (first-line management) of qualified research (as in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments)." Treas. Reg. § 1.41-2(c)(2). "'Direct supervision' does not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist."

If an employee has performed both qualified and non-qualified services, in the absence of another method of allocation that Taxpayer can demonstrate to be more appropriate, the amount of in-house qualifying research expense shall be determined by a ratio of "total time actually spent by the employee in the performance of qualified services" to the total time spent by the employee in the performance of all the services the employee performed. Treas. Reg. § 1.41-2(d).

Taxpayer provided some documentation about the product development projects in which S Corp was engaged during the years at issue. That information does not specifically describe each employee's involvement in the project such that there is documentary evidence of the actual time spent working on the project or the type of qualified service provided by each employee. Also, the employee lists for each of the years at issue contain the name of Taxpayer himself who is the CEO of the company. Unless Taxpayer demonstrates otherwise, he, as CEO, cannot be assumed to be engaged himself in qualified research activities, or of being a front-line supervisor or supporter of those activities.

Taxpayer refers to case law in support of his protest. Taxpayer points to the Department's audit which found – as one of the audit's reasons for disallowing the credit – that the records Taxpayer provided were similar to records provided in United States v. McFerrin, No. H-05-3730 (S.D. Tex. May 12, 2008). McFerrin held that the level of documentation provided by the taxpayer was not sufficient to support the estimate of time spent by skilled tradesmen and engineers on research and development projects. Taxpayer points out that the audit's reference to this case is incorrect because the case was subsequently vacated by the United States Court of Appeals for the Fifth Circuit and remanded for further proceedings consistent with the Fifth Circuit's opinion (See United States v. McFerrin, 570 F.3d 672 (5th Cir. 2009), (emphasis added), which states in relevant part as quoted by Taxpayer:

> The government next argues that even if qualified research occurred, McFerrin failed to provide adequate documentation to substantiate the costs associated with that research. But this goes against the longstanding rule of Cohan v. Commissioner that if a qualified expense occurred, the court should estimate the allowable tax credit. 39 F.2d at 544. If McFerrin can show activities that were "qualified research," then the court should estimate the expenses associated with those activities. The district court need not credit McFerrin's reconstruction of expenses from years after the fact. See Eustace v. Comm'r, 81 T.C.M. (CCH) 1370, *5 (2001). But the court should look to testimony and other evidence, **including the institutional knowledge of employees**, in determining a fair estimate.
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> (**Emphasis added by Taxpayer**).

In other words, the Department's audit refers to a case that was later overruled by a higher court. However, the Department also notes that the McFerrin decision to which Taxpayer cites was issued by the Fifth Circuit Court of Appeals, while Indiana is located in the Seventh Circuit. The McFerrin opinion is therefore not binding on Indiana.

Taxpayer also refers to Efrem v. Comm'r, TC Memo 1994-235 (May 26, 1994), where the court estimated the time spent under the Cohan principles (see Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930)) by two engineers in determining research and development costs in the absence of records detailing the amount of time spent and the activities in which they were engaged. Taxpayer quotes the court:

> Lastly, we must decide how much time petitioner, Mrs. Fudim, and Natalia spent engaged in qualified services during the years in issue. Because petitioner did not produce contemporaneous written records of the time and activities spent by himself, Mrs. Fudim, and Natalia, we must rely on his testimony and other evidence in the record. Based on the record, we have estimated the time spent on research and development under the principles set forth in Cohan v. Commissioner [2 USTC ¶ 489], 39 F.2d 540 (2d Cir. 1930).

In other words, Taxpayer is arguing that the taxpayer in Fudim was allowed to take the credit in spite of the lack of records pursuant to the Cohan rule. Taxpayer should take note, however, that his reference to Efrim has a fuller, more nuanced context. Consider this lengthier quote from Efrim that includes the paragraph quoted by Taxpayer:

> If during the year an employee performed both qualified and nonqualified services, only the amount of wages relating to qualified services constitutes an in-house research expense. Sec. 1.41–2(d)(1), Income Tax Regs. Accordingly, **in the absence of another method of allocation that the taxpayer can demonstrate to be more appropriate, the amount of in-house research expense shall be determined by multiplying the total amount of wages paid or incurred for the employee during the taxable year by the ratio of the total time actually spent by the employee in the performance of qualified services for the taxpayer to the total time spent by the employee in the performance of all services for the taxpayer during the taxable year.** [Id.]
>
> However, if "substantially all", i.e., at least 80 percent, of the services of an employee are qualified services, then all of such employee's services are considered qualified services. Sec. 41(b)(2)(B); sec 1.41–2(d)(2), Income Tax Regs.
>
> Although respondent argues otherwise, we have no doubt that during 1986, 1987, and 1988 petitioner was engaged in research and development for which a research tax credit under section 41 is allowable. His training and background certainly attest to his capability to develop the rapid modeling process. Moreover, the record includes contemporaneous letters and scientific articles acknowledging and describing petitioner's newly developed rapid modeling process. Most importantly, contemporaneously, petitioner was awarded two patents for the rapid modeling process which reflected the results of his research during 1986, 1987, and 1988. The first patent was granted on June 21, 1988, and the other on January 31, 1989.
>
> [...]
>
> Lastly, we must decide how much time petitioner, Mrs. Fudim, and Natalia spent engaged in qualified services during the years in issue. Because petitioner did not produce contemporaneous written records of the time and activities spent by himself, Mrs. Fudim, and Natalia, we must rely on his testimony and other evidence in the record. Based on the record, we have estimated the time spent on research and development under the principles set forth in Cohan v. Commissioner, 39 F.2d 540 (2d Cir.1930). **[this is the paragraph quoted by Taxpayer in its protest brief].**
>
> We are satisfied that, during 1986, 1987, and 1988, petitioner spent more than 80 percent of the time he worked with Light Sculpting engaged in qualified services. Although during those years petitioner derived a substantial amount of income from consulting work for Sundstrand, he was paid, on average, $1,500 a day. At this rate he worked an estimated 12 days, 36 days and 43 days for Sundstrand in 1986, 1987, and 1988, respectively. He also spent only a small amount of his time writing and reviewing articles during the years in issue. Consequently, even if we assume petitioner worked only a 5–day week (and we are convinced he worked more than that), we find that he spent more than 80 percent of his time performing qualified services. We also conclude that Mrs. Fudim spent at least 80 percent of her time in 1987 engaged in qualified services. She is a highly trained engineer proficient in computer programming. With this expertise, she had to have been a substantial help to her husband.
>
> **On the other hand, we simply do not have sufficient information to determine whether Natalia's services were so directed.** The record fails to reveal Natalia's age, training, or level of expertise. Petitioner also failed to present any evidence as to what services Natalia rendered. Therefore, we find that petitioner is not entitled to any research credit based on the wages he paid Natalia.
>
> **(Emphasis added**).
>
> Fudim v. C.I.R. L 223280, 12-13 (U.S. Tax Ct. 1994).

The Taxpayer's reliance on the above referenced cases is mistaken. The Department notes that the Cohan rule is about the deduction of various items under sections 162 and 212. While Fudim applies the Cohan rule to credits, Fudim is a Tax Court Memorandum decision and thus does not represent legal precedent. Nico v. Commissioner, 67 T.C. 647, 654 (1977), aff'd in part and rev'd in part on other issues, 565 F.2d 1234 (2d Cir. 1977); Newman v. Commissioner, 68 T.C. 494, 502 n.4 (1977).

More importantly, Fudim is distinguishable on the facts. First, Fudim involves a husband and wife doing research for their own start-up company where there would be no need for management authorization for expenditures, no need for reports of research activities to management, time reporting, etc. In Cohan the taxpayer had no recordkeeping requirements of his own. Also, in Fudim the court found that the petitioner failed to present sufficient evidence as to what services a third employee, Natalia, had rendered and therefore was not entitled to any research credit based on the wages he paid Natalia.

To conclude, the case law to which Taxpayer cites is distinguishable and does not have precedential value in Indiana. The information and documentation Taxpayer provides is not sufficient to support the percentages allocated to its employees' activities.

It is entirely possible that Taxpayer performs qualified research activities such that it could qualify for the REC. As stated above, similar to deductions, exemptions, and exclusions, tax credits are matters of legislative

grace. The taxpayer who claims a tax credit against any tax is required to retain records necessary to substantiate a claimed credit. In this instance, Taxpayer has not met its burden to show that the disallowance of S Corp's research expense credit was incorrect.

FINDING

Taxpayer's protest is respectfully denied.

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